

Commitment to Sustainability:

INVESTMENT STRATEGIES AT THE

University of Illinois System

F E B R U A R Y 2 0 2 2



Intentional
Endowments
Network

An initiative of www.CraneSustainability.org

Table of Contents

INTRODUCTION	2
HISTORY OF RESPONSIBLE INVESTING	2
2020: FINANCIAL STEWARDSHIP THROUGH RESPONSIBLE INVESTING	3
DIVERSE MANAGERS PROGRAM	4
BLACKROCK ESG INSIGHTS STRATEGY	4
ACTIVE OWNERSHIP	5
SUSTAINABLE FARMING PRACTICES	5
PRIVATE MARKET IMPACT FUNDS	6
INDUSTRY ADVOCACY	6
STUDENT ENGAGEMENT	6
CONCLUSION	6

(Click on page number
for direct link.)

Introduction

The University of Illinois System (U of I System) is composed principally of its three best-in-class universities in Urbana-Champaign, Chicago, and Springfield – enrolling more than 90,000 students each year. Its 2021 operating budget was \$6.74 billion.

The U of I System investment program has \$4.27 billion in assets under management (AUM) in its operating and endowment pools. The endowment includes legacy gifts that were bequest directly to the University, as well as a portion of the operating cash and other funds. It is separate from the University of Illinois Foundation.

The investment program launched the Empowering Excellence: Financial Stewardship through Responsible Investing initiative in 2020, which is guided by the U of I System's Guiding Principles and the Illinois Sustainable Investing Act. Six sub-components form the initiative: seeding an ESG Insights strategy managed by BlackRock, active ownership, sustainable farming practices, private market impact funds, industry advocacy, and student engagement.

While there are many other sustainability initiatives happening within the U of I System and its three campuses, for the purpose of this case study, the focus is limited to the investment program.¹

HISTORY OF RESPONSIBLE INVESTING

A student coalition in 1977 called the Champaign Urbana Coalition Against Apartheid encouraged the University of Illinois to divest from South African connected corporations. Like on many campuses in the US, the South Africa divestment movement sparked broader conversations on endowments and responsible investment strategies.

After more than a decade of careful consideration, the U of I System established its responsible investing program in 2020. Many of the historical concerns that prevented the U of I System from formalizing a program sooner ultimately served as the basis in the design of the program. These concerns included the importance of maintaining the university's fiduciary duty, the preservation of its voice with invested companies that could be lost through broad divestment mandates, inclusivity of the entire University community, and the absence of existing products in the market that aligned with the U of I System's desired approach.

¹ See the University of Illinois Urbana-Champaign's Institute for Sustainability, Energy, and Environment website for more:

<https://sustainability.illinois.edu/campus-sustainability/>

THE U OF I SYSTEM'S FIDUCIARY DUTY was paramount in the design of the responsible investment program with a clear intention of reducing risk while identifying investment opportunities that prioritize both strong returns and positive impact. The program affects positive change in corporate practice through management engagement and proxy voting with invested companies. It is inclusive of the campus community and is designed to lead a broader shift towards responsible investing by partnering in the development of accessible, low cost sustainable investment products and services.

2020 – Empowering Excellence: Financial Stewardship through Responsible Investing

U of I System President—Tim Killeen—is a champion of climate science. Killeen took office at the U of I System in 2015, and since has helped increase campus research initiatives on sustainability. President Killeen has developed a culture of innovation across the U of I System, and as such, charged the investment team with designing an industry-leading financial sustainability program that prioritizes not only returns and impact, but that also considers the entirety of the University community.

As such, in 2020, the U of I System announced the establishment of the Empowering Excellence: Financial Stewardship through Responsible Investing program (“The Program”). The Program was formed based on the U of I System’s Guiding Principles and Illinois Sustainable Investing Act.

THE GUIDING PRINCIPLES:

In the summers of 2017 and 2019, staff, students, and trustees worked together to create the U of I System’s guiding principles. These principles cover a broad spectrum of topics and accountability within and outside the university. The principles are: (1) freedom of speech, (2) globalization & immigration,

(3) civic engagement, (4) excellence with integrity, (5) fostering healthy relationships across campuses, and (6) financial & environmental sustainability. The guiding principles are an integral part of the U of I System actions in all aspects of their work moving forward and are intended to be living documents.

ILLINOIS SUSTAINABLE INVESTING ACT:

The Sustainable Investing Act was signed into law in August of 2019 with an effective date of January 1st of 2020. The Act calls for public agencies to develop sustainable investment policies and integrate ESG factors into decision-making.

In consultation with the Board of Trustees, the Investment Policy Statement (IPS) was concurrently updated to include a reference to the Illinois Sustainable Investing Act. It is notable that the IPS directive is intentionally flexible with the knowledge that the responsible investing environment and market continually evolves. This flexibility provides the Board of Trustees and staff with the ability to be better fiduciaries and have a greater impact if as they are able to pivot to address ESG risks and opportunities as they arise.



*... in 2020 the U of I System announced an innovative approach to responsible investing with the establishment of the **Empowering Excellence: Financial Stewardship through Responsible Investing** program.*

The Program was designed to achieve four primary objectives:

- *Have a tangible impact* – driving actions with measurable benefits
- *Be evolutionary* – serving as a flexible framework rather than a fixed solution
- *Be groundbreaking* – moving past the limitations of existing frameworks
- *Be grounded in fiduciary duty* – keeping fiduciary duty paramount

To achieve the objectives, six main components were identified: seeding an ESG Insights strategy managed by BlackRock, active ownership, sustainable farming practices, private market impact funds, industry advocacy, and student engagement.

Cutting across The Program is a long-standing effort to allocate to diverse and minority-owned firms.

While the program is intended to evolve and grow over time, progress to date on each of the initiatives is discussed below.

Diverse Managers Program

MAIN GOAL:

Promote and support diversity within the investment industry through the intentional allocation of capital to minority-owned firms.

Over the past decade, the University's endowment built a 25% allocation to minority-owned firms. Early efforts to establish this allocation via dedicated exposure in public active equity produced mixed results. After considering that the probability of active management outperformance in public equities is

substantially lower than in fixed income markets, the U of I System decided to shift this mandate accordingly to provide the best chance of success for this group of managers. Since inception in 2017, this allocation has consistently met the benchmark on a net of fee basis.

BlackRock ESG Insights Strategy

MAIN GOAL:

Seeded the new strategy using BlackRock's proprietary environmental, social, and governance factors driven by financial materiality. Our decision to seed this strategy is intended to not only invest the U of I System's U.S. equity allocation in line with its mission, but also to provide a cost efficient, ESG-focused alternative for the more than \$4.3 trillion invested globally in passively managed U.S. equity strategies.

System leaders partnered closely with BlackRock in the design of the ESG Insights strategy to confirm that the ESG factors aligned with the U of I System's Guiding Principles and the Illinois Sustainable Investing Act. In April 2020, the endowment's U.S. equity allocation (\$160 million of \$760 million endowment pool at the time) was transferred to seed the strategy.

The strategy scores companies based on the financial materiality of 15 ESG issues, including GHG emissions, clean technology, water & wastewater management, inclusion & diversity, and board independence. The scores are derived from multiple data sources, including proprietary BlackRock information. The strategy seeks to maximize exposure to sustainability-related factors by over- and underweighting individual companies based on ESG scoring, subject to risk constraints relative to the Russell 3000.



*Staff are confident in their fiduciary duty, as the strategy **reinforces a preference for low-cost investments in efficient markets** with pricing comparable to the prior passive equity investment.*

The strategy exhibits strong alignment with the U of I System's investment philosophy. Staff are confident in their fiduciary duty, as the strategy reinforces a preference for investments in efficient markets with pricing comparable to the prior passive equity investment. Consideration of financial materiality in the ESG factors is unique in the industry and furthers the importance of fiduciary considerations. The U of I System's investment staff view BlackRock's stewardship efforts, including management engagement and proxy voting (further discussed in the Active Ownership component), as an important mechanism to encourage sustainable business practices. As of 6/30/2021, the U of I System's \$160 million investment had grown to \$252 million, returning 47% on an annualized basis and outperforming its benchmark (Russell 3000) by 1.2%.² The investment staff plan to continue to evaluate the strategy over the market cycle and may consider expansion into the endowment's international public equity allocation in the future.

Active Ownership

MAIN GOAL:

Affect change in the companies in which the U of I System is invested through meaningful shareholder advocacy practices.

A driving force behind the U of I System's decision to seed the BlackRock ESG Insights strategy was a strong conviction that BlackRock would make a measurable impact on invested companies on their behalf through its shareholder advocacy practices. BlackRock has a long track-record of engaging with companies to provide feedback to boards and management, using their voice as an investor on behalf of their clients to encourage practices aligned with long-term value creation. For example, BlackRock asks that companies clearly articulate how they are aligned to a scenario in which global warming is limited to well below 2° C, consistent with a global aspiration to reach net zero greenhouse gas emissions by 2050. BlackRock



*The U of I System's investment program is unique to its peers in its allocation to farmland with a **total of 10,774 internally managed acres.***

may vote against directors when companies don't demonstrate sound practices. BlackRock has published its policies on a range of governance and sustainability issues. During the 2020-2021 proxy year, BlackRock voted against management on one or more proposals at 42% of meetings and voted to remove directors in 6,560 instances.

Sustainable Farming Practices

MAIN GOAL:

Partner with endowment farm operators and private farmland funds to incorporate sustainable farming practices.

The U of I System's investment program is unique to its peers in its allocation to farmland with a total of 10,774 internally managed acres. This tangible component of the U of I System's responsible investing program is established as sustainability and conservation practices serve as a key factor not only in the selection of their operators, but also in their ongoing dialogue throughout the term of the engagement. Water quality research is a high priority for their operator community. One operator was able to meaningfully reduce nitrogen infiltration in groundwater through a series of experiments whereby nitrogen levels were monitored real-time, pinpointing ideal application levels and reducing runoff. Their operators are also taking steps toward the renewable energy transition. One operator has achieved both monetary and environmental gains by moving 100% of grain drying on-premise and attaching solar panels to the top of a machine shed to power all outbuildings. Their operators also participate in USDA-FSA programs, such as CRP and Pollinator Habitat Initiative. These programs put acres back in their natural habitat, reduce erosion, increase habitats for pollinators, and encourage weed control on neighboring grain producing land. The U of I System has consistently found the farm operators to be highly receptive to these practices and willing to partner in identifying unique methods for improving soil and protecting the environment.

²Performance data was internally calculated by the University of Illinois System investment staff.

In addition to the University-owned farmland allocation, the U of I System's endowment has both expanded and diversified this allocation through the addition of a private U.S. farmland fund. The fund aligns closely with the University in its embedded focus on ESG throughout due diligence and underwriting, portfolio construction and active portfolio management.

Private Market Impact Funds

MAIN GOAL:

Consider opportunistic private market funds with the disclosed intention to generate and measure social and environmental benefits while continuing to hold fiduciary duty paramount.

The endowment's first private market ESG investment closed in September 2021. While consideration had been given to traditional impact funds, concerns around rich valuations prompted the investment team to consider innovative alternatives. As headlines began to appear around a major shortage of inputs required for a successful energy transition, the investment team was presented with a private equity mining fund that focused on nickel, copper, and battery materials. A strong track record was complemented by a focus on ESG practices within the mines, making this investment an ideal candidate for the program.

Industry Advocacy

MAIN GOAL:

Encourage strong ESG practices in the industry through our partnerships with investment firms.

This subcomponent involves urging investment firms to expand their ESG practices. This is accomplished through discussions around diversity and encouragement in becoming signatories of the UN Principles for Responsible Investment (PRI). The investment team has engaged with its partner firms on these issues over the past decade and has received ongoing progress reports, particularly from the firms that were lacking in these areas. Furthermore, the U of I System engages with endowment peers and investment industry actors through its membership and participation in the Intentional Endowments Network (IEN).

Student Engagement

MAIN GOAL:

Foster collaboration with interested student groups.

The focus of the student engagement subcomponent is to become the model for higher education institutions in stakeholder collaboration. To date, the U of I System has incorporated the ESG focus into its investment policy statement and hired its first ESG intern. Plans to host student engagement sessions have been postponed due to the pandemic but are expected to become a key tool for fostering collaboration into the future.

Conclusion

The University of Illinois System provides a compelling approach for endowment leadership on mission aligned investing. It demonstrates that a primary focus on fiduciary duty can enable an ESG and impact investing strategy. The U of I System's program takes a multi-faceted approach across asset classes that is both impactful and flexible, ensuring that the team can adapt to changing circumstances over the long term.

Accordingly, the U of I System's process also provides another example of the many ways endowments can follow the steps laid out in IEN's *Intentionally Designed Endowment Roadmap* (<https://www.intentionalendowments.org/roadmap>) to educate and learn; build consensus; develop policies; implement those policies; and communicate to stakeholders. It provides one model of how endowments can design sustainable investing strategies to protect capital, enhance returns, and contribute to a more healthy, just, and sustainable economy.

Acknowledgements

WE ARE GRATEFUL FOR THE CONTRIBUTIONS TO RESEARCHING,
WRITING, AND REVIEWING THIS CASE STUDY FROM:

Georges Dyer, Intentional Endowments Network

Haley Obermeier, Intentional Endowments Network

Siobhan Pender, Intentional Endowments Network

Geri Melchiorre, University of Illinois System

Hannah Leischner, University of Illinois System



An initiative of www.CraneSustainability.org

Intentional Endowments Network, January 2022